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FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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APR 3 1992
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(Mark One)

(X) QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 1, 1992

92-2236

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ TO _____

Commission file number 0-12672

PROCESSED BY
APR 08 1992

TELCO SYSTEMS, INC (DE)
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction incorporation or organization)

Microfilmed by
Q-Data Corp. - St. Petersburg, FL

L3Q

identification no.)

63 NAHATAN STREET, NORWOOD, MASSACHUSETTS 02062
(Address of principal executive offices)

Registrant's telephone number, including area code: (617) 551-0300

NO CHANGE
(Former name, former address and former fiscal year, if change since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES X NO___

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Classes	Outstanding at March 30, 1992
Common Stock, $.01 par value	9,215,077

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TELCO SYSTEMS, INC.

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REPORT ON FORM 10-Q

FOR QUARTER ENDED MARCH 1, 1992

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELCO SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands except per share data)

	March 1, 1992 Unaudited	August 25, 1991 Audited
Assets		
Current assets:		
Cash and equivalents	$26,508	$25,419
Accounts receivable	15,838	20,197
Inventories	19,196	16,372
Other current assets	1,343	1,248
Total current assets	62,885	63,236
Plant and equipment, at cost	30,234	28,590
Less accumulated depreciation	19,970	18,965
Net plant and equipment	10,264	9,625
Intangible and other assets, net	10,118	10,339
Total assets	$83,267	$83,200
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 3,515	$ 5,642
Payroll and payroll related liabilities	1,251	1,597
Other accrued liabilities	4,991	5,247
Current portion of long-term liabilities	2,000	2,000
Total current liabilities	11,757	14,486
Long term liabilities	5,261	7,295
Shareholders' Equity:		
Preferred stock, $.01 par value, 5,000,000 shares authorized; no shares outstanding at March 1, 1992 and August 25, 1991	-	-
Common stock, $.01 par value, 24,000,000 shares authorized; shares outstanding: 9,200,158 at March 1, 1992; 8,832,667 at August 25, 1991	92	88
Capital in excess of par value	62,182	60,616
Retained earnings	3,975	715
Total shareholders' equity	66,249	61,419
Total liabilities and shareholders' equity	$83,267	$83,200

See accompanying notes to consolidated financial statements.

TELCO SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Dollars in thousands except per share data)

	Three Months Ended		Six Months Ended*	
	March 1, 1992	Feb. 24, 1991	March 1, 1992	Feb. 24 1991
Sales:				
Fiber optic transmission products	$ 15,211	$ 15,058	$ 32,885	$ 29,565
Customer premise network access equipment	6,978	9,602	15,504	17,720
	22,189	24,660	48,389	47,285
Cost and expenses:				
Cost of products sold	12,602	14,414	27,900	28,300
Research and development	2,561	1,909	5,272	3,722
Sales, marketing and administration	5,052	5,087	10,047	9,757
Amortization of intangible assets	151	150	301	301
Interest expense	211	235	461	533
Interest income	(293)	(298)	(687)	(691)
	20,284	21,497	43,294	41,922
Income before income taxes	1,905	3,163	5,095	5,363
Provision for income taxes	675	753	1,835	1,283
Net income	$ 1,230	$ 2,410	$ 3,260	$ 4,080
Average number of shares and equivalents	9,524,594	9,362,741	9,550,433	9,287,095
Earnings per share	$ 0.13	$ 0.26	$ 0.34	$ 0.44

The 1992 six-month period includes 27 weeks vs. 26 weeks in the 1991 six-month period.

See accompanying notes to consolidated financial statements.

TELCO SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Dollars in thousands except per share data)

	Six months ended	
	March 1, 1992	February 24, 1991
INCREASE (DECREASE) IN CASH AND EQUIVALENTS *		
Cash flows from operating activities:		
Net income	$ 3,260	$ 4,080
Depreciation and amortization	1,823	1,617
	5,083	5,697
Change in assets and liabilities:		
Accounts receivable	4,359	(688)
Inventories	(2,824)	(2,403)
Other current assets	(95)	34
Intangible and other assets	108	-
Accounts payable and other current liabilities	(2,729)	(88)
Long-term liabilities	(34)	97
	(1,215)	(3,048)
Net cash provided by operating activities	3,868	2,649
Cash flows from investing activities:		
Additions to plant and equipment, net	(2,087)	(4,023)
Other investing activities	(262)	--
Net cash (used in) investing activities	(2,349)	(4,023)
Cash flows from financing activities:		
Proceeds from sale of common shares under employee stock plans	1,570	290
Payments on long-term liabilities	(2,000)	(2,350)
Net cash (used in) financing activities	(430)	(2,060)
Increase (decrease) in cash and equivalents	1,089	(3,434)
Cash and equivalents at beginning of year	25,419	21,197
Cash and equivalents at end of period	$26,508	$ 17,763

See accompanying notes to consolidated financial statements.

TELCO SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - The information reflects all adjustments, which are in the opinion of management necessary for a fair statement of the results for the interim periods presented. These interim adjustments are of a normal recurring nature. These condensed consolidated financial statements do not include all disclosures associated with the annual financial statements and accordingly should be read in conjunction with the consolidated financial statements included in the Company's 1991 Annual Report on Form 10-K.

Note 2 - Inventories (dollars in thousands)

	March 1 1992	August 25 1991
Raw materials	$ 7,934	$ 6,928
Work-in-process	4,784	4,361
Finished goods	6,478	5,083
	$ 19,196	$16,372

Note 3 - Shares Reserved and Outstanding

Changes in shares outstanding:

	Common Stock
Outstanding at August 25, 1991	8,832,667
Options exercised	360,018
Employee stock purchase plan	7,473
Outstanding at March 1, 1992	9,200,158

Shares of common stock are reserved as follows:

	March 1 1992	August 25 1991
Convertible subordinated notes	285,714	380,952
Employee stock option plans	1,265,712	1,635,615
Employee stock purchase plan	135,651	143,124
	1,687,077	2,159,691

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following table sets forth for the period indicated (i) percentages which certain items reflected in the financial data bear to sales of the Company and (ii) the percent change of such items as compared to the indicated prior period. See Consolidated Statements of Income.

	PERCENT OF SALES SECOND QUARTER ENDED		PERCENT OF SALES SIX MONTHS ENDED		PERCENT INCREASE/DECREASE SECOND QUARTER ENDED	PERCENT INCREASE/DECREASE SIX MONTHS ENDED
	1992	1991	1992	1991	1992 VS. 1991	1992 VS. 1991
Net sales	100.0%	100.0%	100.0%	100.0%	-10.0%	2.3%
Costs and expenses:						
Costs of products sold	56.7%	58.5%	57.6%	59.9%	-12.6%	-1.4%
Research and development	11.5%	7.7%	10.9%	7.9%	34.2%	41.6%
Sales, marketing and administration	22.8%	20.6%	20.8%	20.7%	-1.0%	3.0%
Amortization of intangible assets	0.7%	0.6%	0.6%	0.6%	-0.7%	0.0%
Interest expense	1.0%	1.0%	1.0%	1.1%	-10.2%	-13.5%
Interest income	-1.3%	-1.2%	-1.4%	-1.5%	-1.7%	0.6%
Total costs and expenses	91.4%	87.2%	89.5%	88.7%	-5.6%	3.3%
Income before income taxes	8.6%	12.8%	10.5%	11.3%	-39.7%	-5.0%
Provision for income taxes	3.0%	3.0%	3.8%	2.7%	-10.4%	43.0%
Net income	5.6%	9.8%	6.7%	8.6%	-43.0%	-20.1%

TELCO SYSTEMS, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

SALES - During the second quarter of fiscal 1992, sales decreased 10% compared with the second quarter of last year. For the six month period, sales increased 2% over the six month period of last year.

Sales of the Company's T1 network access products declined 27% and 13% during the second quarter and first six months of fiscal 1992, respectively, compared with the same periods of last year. These decreases resulted from tighter customer inventory management practices and the sluggish economic environment. In the fiber optic products area, sales for the second quarter and first six months of fiscal 1992 increased 1% and 11%, respectively, compared with the second quarter and first six months of last year. Sales to Bell Operating Company customers and other service providers increased at a less than expected rate for products used in local loop applications.

The outlook for sales and earnings for the balance of the fiscal year is difficult to assess. The Company is facing a changing telecommunication's market environment coupled with the continuing recession. Earnings are expected to remain under pressure as research and development expenditures continue to increase for products critical to expanding our market position. Over the longer term, the Company's planned introduction of new fiber optic transmission products and enhanced T1 access multiplexers should provide excellent opportunities in our two market areas. Due to the uncertain outlook, management will closely monitor market and customer order trends and adjust expense levels and short-term strategies as necessary.

COST OF PRODUCTS SOLD - Cost of products sold amounted to 57% and 58% of sales during the second quarter and first six months of fiscal 1992, respectively, compared with 59% and 60% during the comparable periods of last year. These improvements in gross margin resulted from benefits relating to cost reduction programs and an improved product mix.

RESEARCH AND DEVELOPMENT - During the second quarter and first six months of fiscal 1992, research and development expense was $2,561,000 and $5,272,000, respectively, an increase of 34% and 42% compared with the same periods of last year. These increases resulted from higher spending on next generation SONET transmission equipment and enhancements to T1 access intelligent multiplexers. Research and development represented 12% and 11% of sales in the second quarter and first six months of fiscal 1992, versus 8% in each of the comparable periods of last year. The Company expects R&D spending for these important new products to continue at an increasing rate for the remainder of fiscal 1992.

SALES, MARKETING AND ADMINISTRATION - Sales, marketing and administration expense was $5,052,000 and $10,047,000 for the second quarter and first six months of fiscal 1992, respectively. This represents a decrease of about 1% for the second quarter and an increase of about 3% in the year to date period. The decrease resulted from certain cost reduction initiatives undertaken during the second quarter of fiscal 1992. The increase in the six month period was primarily related to a higher level of advertising and marketing activities in the first quarter of fiscal 1992.

INTEREST EXPENSE - Interest expense was $211,000 and $461,000 for the second quarter and first six months of fiscal 1992, respectively, reflecting a decrease of 10% and 14% compared with the same periods of last year. Interest expense relates primarily to the Company's 11% convertible subordinated debentures which are reduced by annual sinking fund payments of $2.0 million. The most recent payment made in January of 1992 leaves an outstanding balance of $6.0 million at March 1, 1992.

INTEREST INCOME - During the second quarter and first six months of fiscal 1992, interest income amounted to $293,000 and $687,000, respectively. In comparison, interest income was $298,000 and $691,000 for the same periods of fiscal 1991. These decreases resulted from lower short-term interest rates offset by higher average short-term investments.

PROVISION FOR INCOME TAXES - Income tax expense represented 35% and 36% of income before taxes in the second quarter and first six months of fiscal 1992 which compares to 24% in each of the periods of last year. The higher effective tax rates reflect the Company's estimate of its Federal and State tax rate for fiscal 1992 excluding net operating loss carryforwards which were fully utilized in fiscal 1991.

LIQUIDITY AND CAPITAL RESOURCES - For the six month period ended March 1, 1992, cash and equivalents increased by $1,069,000 resulting in a cash balance of $26,508,000. Cash provided by operating activities of $3,868,000 was partially offset by cash consumed in investing activities and financing activities of ($2,349,000) and ($430,000),respectively.

Net cash provided by operating activities of $3,868,000 increased $1,219,000 over the first six months of last year. This was principally related to a decrease in accounts receivable of $4,359,000, which was partially offset by an increase in inventories of ($2,824,000) and a lower accounts payable and other current liabilities of ($2,729,000). The lower receivables and accounts payable levels reflected the reduced sales level for the second quarter period of fiscal 1992 versus fiscal 1991.

Investing activities consumed cash in the amount of ($2,349,000) primarily for facility and equipment upgrades, compared with ($4,023,000) in the six month period of the preceding year. The prior year period included heavy purchases in engineering laboratory equipment.

Financing activities used ($430,000) of cash and consisting of a sinking fund payment of ($2,000,000) for the Company's 11% convertible subordinated notes offset by proceeds from sales of the Company's common stock under various employee stock plans in the amount of $1,570,000.

The Company maintains a $10 million line of credit with the Bank of Boston which expires on March 31, 1994. Borrowings may be made at the bank's prime rate. At March 1, 1992 and August 25, 1991, the Company had no borrowing on this line of credit and had no short term debt outstanding. Management believes that existing cash reserves and future cash flows will be adequate to satisfy cash requirements for continuing operations.

OTHER FINANCIAL INFORMATION - New orders received during the second quarter totaled $17.9 compared to $23.1 million in the second quarter of last year. For the six month period of this year, new orders were $47.0 million compared with $46.9 million last year. At the end of the second quarter, the backlog of unfilled orders shippable within one year decreased to $3.3 million, from $8.6 million at the beginning of the fiscal year. The Company's order trends continue to be characterized by short customer-delivery cycles. Accordingly, a substantial amount of revenues in each quarter are derived from orders booked in the period, as such a decline in orders would have an immediate impact on revenues and profitability.

PART II. OTHER INFORMATION

Item 6. Exhibits and Reports filed on Form 8-K

(b) The Company filed no reports on Form 8-K during the fiscal quarter for which this report is filed.

TELCO SYSTEMS, INC.

SIGNATURE(S)

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TELCO SYSTEMS, INC.

By: _____
John A. Ruggiero
Executive Vice President
Chief Financial Officer